Update on Japanese Bad Debt Restructuring

Economic Deregulation:
Prospects and Challenges for Japan and Asia

March 21, 1997

The Kellogg Conference Center
Columbia University

(Revised in April 1997)

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Abstract

Over the past few years, Japan has slowly entered into the process of bad debt restructuring. This process is taking place in two phases: an initial phase of bad debt restructuring, namely the consolidation of ownership of bad assets, which is now surfacing as bad asset receptors are being established; and a second phase, regarding the dispersion of ownership of bad assets, which has not yet emerged but will occur gradually over the next five years. The author explores a range of investment opportunities that are emerging as this restructuring process takes place. Particularly, two developments from last summer -- the establishment of the Housing Loan Administration Corporation and the Resolution and Collection Bank -- indicate that borrowers from *Jusen* companies and failed credit co-ops are no longer supported by the Japanese banking system. These borrowers, largely real estate developers many of whom are already technically insolvent, have been left with no other alternative but significant reorganization including the total liquidation of assets. Opportunities are arising from these bankruptcy/liquidation sales. Another area of opportunity lies in the increasing consolidation among banks, particularly among smaller *shinkin* and second-tier regional banks which have been left without any specific official rescue packages due to the current political climate. As they consolidate there will be a further growth of opportunities for investors.

Introduction[1]

Over the past few years, Japan has slowly entered into the process of bad debt restructuring. This process is taking place in two phases. An initial phase of bad debt restructuring, namely the consolidation of ownership of bad assets, is now surfacing as bad asset receptors are being established. The second phase, regarding the dispersion of ownership of bad assets, has not yet emerged but will occur in the next five years albeit at a gradual pace.

There are some investment opportunities that are coming about as this process takes place. The first phase mentioned above is already underway and has started to be felt by investors. Particularly, two developments from last summer -- the establishment of the Housing Loan Administration Corporation and the Resolution and Collection Bank -- indicate that borrowers from Jusen companies and failed credit co-ops are no longer supported by the Japanese banking system. These borrowers, largely real estate developers many of whom are already technically insolvent, have been left with no other alternatives but significant reorganization including the total liquidation of assets. Opportunities are coming out of these bankruptcy or liquidation sales. Another area of opportunity lies in the fact that there is increasing consolidation among banks, particularly among smaller shinkin and second-tier regional banks which have been left without any specific official rescue packages due to the current political climate. As they consolidate there will be a further growth of opportunities for investors.

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[1] An earlier version of this article was presented at the Third Annual Conference on Distressed Debt in New York on December 9, 1996.

Background

What occurred in Japan during the 1980's and the first half of the 1990's was predicated on earlier developments in the Japanese economic system; the very well designed Japanese economic system which had helped create an economic miracle after World War II also created an economic environment in the 80's and early 90's that was replete with moral hazards. Within this highly regulated and over-protected environment, the banking industry became disinclined to pursue rigorous credit standards or develop effective risk management methods and, in time, it became susceptible to moral hazard behavior.

In the postwar economy, the Japanese regulations produced a remarkably well coordinated financing system that supported rapid growth in key manufacturing industries. Due to the policies of the government, these key industries were initially protected from external competition but eventually succeeded in converting themselves into fierce international exporters in the world market. The banking industry helped to coordinate manufacturing efforts and then likewise expanded toward international areas. Initially the banks concerned themselves with financing key industries and did not worry about external competition since there were so many attractive lending opportunities available domestically. The Ministry of Finance helped to guide the banking industry by providing an over-all strategy which adapted the military concept of "goso sendan hoshiki" (or military fleet system or convoy system) in order to execute and promote domestic efforts. "Goso sendan hoshiki" became synonymous with a regulatory method whose central characteristic was to prevent failure in weaker banks. Eventually as the economy grew and began globalizing, the banking industry confronted a market-induced "de-regulation" in the late 1970's and early 1980's which was controlled by a cautious MoF. Increasingly the Japanese system became more exposed to the outside world where, unlike the domestic Japanese market, sheer market forces dictated who would succeed as risk takers. Following the 1985 Plaza Accord, Japanese policy makers decided to loosen monetary policy in order to mitigate a deflationary effect created by rapid yen appreciation. With this decision, the micro-managed Japanese financial system backfired, moving away from its intended purpose and eventually becoming dysfunctional. This happened because lenders loosen credit criteria and their incentive structure became increasingly distorted. The discretionary, haphazard regulations implemented by "goso sendan hoshiki" produced a situation that reflected the classic understanding that over-regulation encourages self-defeating actions and can weaken economic structure. The logic of economics has convincingly argued that individual financial institutions should be left to take responsibility for their own strategic planning and risk taking. Throughout the post war period, the MoF regulators had not encouraged individual financial institutions to develop their own risk management programs because of concerns about how they would interact, and perhaps interfere, with MoF micro-management. Combined with an easy monetary policy, the situation was ripe for financial institutions to lose self-discipline and exhibit textbook moral hazard behavior. In fact bureaucrats themselves demonstrated a loss of self-discipline which the Japanese public, somewhat ingenuously, had accepted as an article of cultural faith. The most notable instance of this was the MoF's ineffective handling of the Jusen resolution which was influenced by the stake that MoF parties held in Jusen; in addition to being the creator of the Jusen, for many years there had been a steady stream of retired MoF bureaucrats who found a second career at Jusen companies. In short, the post-war regulatory environment allowed financial institutions to exhibit moral hazard behavior which led to the current situation; Japan leads the world in accumulation of bad debt which is estimated at levels from $250 billion to more than $1 trillion.

The post-war "goso sendan hoshiki" method also produced another obvious outcome that presently concerns investment professionals; there are too many inefficient banks existing in Japan. Due to increasing world market pressure and corresponding changes in regulatory policy, we should see an increasing number of consolidations among banks. It is interesting to note that all of the Japanese banks have failed in the last few years are smaller banks which have been regulated by the Small Financial Institution Division of the Banking Bureau of the MoF or prefectural governments. To date none of the larger banks which are regulated by the Banking Division have failed; this is because the MoF has been successful in finding financially sound banks to acquire those that are weaker and may be prone to failure. The Banking Division regulates all of the city banks, long-term credit banks, trust banks and first-tier regional banks. The second-tier regional banks and shinyo kinko (shinkin banks) are regulated by the Small Financial Institution Division. Shinyo kumiai (credit cooperatives) are regulated by prefectural governments.

Phase I of Bad Debts Restructuring

Despite the idiosyncratic nature of the Japanese socio-economic system, Japan has started showing similar reactions to the massive amount of non-performing assets that one can find in other countries around the world. Admittedly the pace of restructuring has been very slow and roundabout. However there are some recognizable patterns emerging. Over the last four years, financial institutions and regulatory agencies have created several centralized receptors of bad debts which have affected ownership consolidation of those assets. In December 1992, the Cooperative Credit Purchasing Company, Ltd., (or CCPC) was established as a centralized receptor by the Bankers Association of Japan. In March 1993, Japanese banks began the process of selling their bad debts to CCPC. In 1994, through a series of administrative measures, Japanese banks were individually allowed to establish "bad banks" (in the form of "SPC") in order to facilitate bad debt restructuring. Further, banks were allowed to establish property auction subsidiaries (real estate holding subsidiaries) individually or jointly with other banks in order to acquire collateral real estate properties at court-administered foreclosure auctions. In 1995, Tokyo Kyodo Bank was established to hold the assets of two failed credit co-ops in Tokyo. In 1996, after a long but unproductive political debate in the parliament, the Housing Loan Administration Corporation and the Resolution and Collection Bank were concurrently established. The former were created to hold Jusen assets; the latter was created to hold failed credit co-ops' assets (the Resolution and Collection Bank was developed from the restructured Tokyo Kyodo Bank). These two institutions were organized as subsidiaries of the Deposit Insurance Corporation of Japan (DIC). This is interesting because it is common knowledge that

Jusen companies were not deposit taking institutions and therefore had never been covered by DIC nor had they paid deposit insurance premiums.

Phase II of Bad Debt Restructuring

Phase II, or the dispersion of bad debt asset ownership, has not gotten off the ground according to most analysts and the timing of its arrival is still uncertain. Currently the ownership of "bad banks", created by the industry or individual banks such as CCPC, SPC, or real estate holding subsidiaries, remains closely held by "good banks". The U.S. experience strongly suggests that the success of a "good bank - bad bank" structure hinges on how quickly bad banks can disperse their shares to a wider shareholder base. For example, in the late 1980's the equity shares of Grant Street National Bank were distributed as stock dividends to Mellon Bank shareholders when it was established as a bad bank of Mellon Bank. More recently, several Swedish good banks have distributed their bad bank subsidiary shares to their shareholders and one of these good banks, Swed Bank, distributed shares of its wholly owned Tornet subsidiary last spring. This spin-off to shareholders of the parent good bank has simplified the mandate given to bad bank managers; they can now focus on restructuring without interference from the parent good banks. And furthermore these managers can become more aggressive in their asset disposition programs. As it stands now in Japan, the distribution of bad bank shares as stock dividends is taxable (subject to double taxation) which makes such distribution unlikely to occur. The

Swedish took the decisive measure of amending their National Income Tax Act in order to facilitate the distribution of bad bank shares.

As for the two earlier mentioned subsidiaries of DIC, they clearly need to start privatization programs for nationalized assets held by them but it is very unclear when this process will start. A vague concept of "securitization" has frequently been mentioned by those involved in these institutions as the panacea to the current Japanese problems. But the legal structure in Japan is not flexible enough to allow banks to quickly and efficiently move portfolio transactions along. Increasingly it seems that people are becoming aware of these problems. Currently several ministries are said to have organized working groups consisting of bureaucrats, academics and industry professionals to consider ways in which Japanese bad debts might be securitized. In my own opinion, it is not clear whether the Japanese have addressed the real issues regarding securitization. One of the most significant issues is how to proceed efficiently when there are no liquidities in the underlying assets of portfolios under consideration. It worries me that the recently established working groups are diligently addressing legal, regulatory and tax aspects but are not conceptualizing more relevant economic aspects of securitization and future transactions. For the most part, it appears that the goal of study groups is to produce reports rather than produce business. It is difficult to predict when bad debt transactions may occur in Japan because, at present, the professional business planning that should precede these transactions is not being laid out. The process would undoubtedly become clearer if information gathering and business development groundwork, even at the level of official working groups, were organized based on the concept of business incentive before disposition programs are initiated.

Impediments to Bad Debt Restructuring

When observers try to understand what is happening in Japan regarding the resolution of bad debt problems, they often are left with a feeling that, particularly among regulatory planners and bankers, there is a general distrust toward the market mechanism. Japanese regulatory planners and bankers are hesitant to view the market as an efficient conflict resolution mechanism. This distrust of the market may explain partly why the MoF prefers micro-managing the financial industry. The process of globalization experienced over the last two decades, however, has forced Japanese to recognize market forces as a guiding principle for economic planning and business decision making. This recognition originated in the international business arena and has spread into the domestic business areas. However Japanese leaders still seem unable to accept the resulting labor force displacement and widening income gap which accompany market solutions, but, which Japanese authorities and the wider public have viewed as a major cause of social instability in the U.S. and Europe.

The banking industry in Japan exhibits characteristics of a well protected and not so efficient industry. These characteristics have been accentuated in the area of risk management. In basic banking activities, lending decisions have tended to be based on relationships with borrowers rather than on strict credit consideration. And the strong emphasis on relationship has made creditors extremely reluctant to force defaults. Many creditors would rather lend additional amounts to cover interest payments, or leave borrowers alone, than send out default notices. This helps to explain why, even in the area of real estate financing, the concept of non-recourse lending has not received wide acceptance. In most Japanese domestic loans, creditors do not insist on full control of collateral assets until borrowers become completely insolvent or declare bankruptcy. Therefore, borrowers frequently use the same collateral assets to secure different loans from other lenders. As long as a new loan is subordinated to an existing loan, the existing creditors have traditionally not kept borrowers from incurring additional debt. As a result, it is common in the real estate registry to see loans secured by a property with multiple (numerous) liens on it. Further, due to strong and long-standing bank-borrower relationships, the domestic syndicated loan market has not developed well in Japan and as a result, shared national credits virtually do not exist in Japan. This fact has certainly impeded the trading of bank loans.

In the U.S. it is not only customary but legally required that systematic and uniform financial information be disclosed; however in Japan there are no similar requirements nor are there strict mark-to-market requirements for balance sheet (therefore, also off-balance sheet) items. In addition, the loan classification criteria are not standardized to the degree that they are in the U.S. and can be, to some significant degree, discretionary. During recent events there have been steps taken to improve areas related financial disclosure, mark-to-market and loan classification. But it continues to be difficult to make comparisons among domestic institutions because the investing public remains unconvinced that publicly disclosed information reveals the true financial status of companies under discussion.

Other barriers to a market oriented resolution of bad debts exist within the Japanese legal system. The current court system, bankruptcy laws and judicial foreclosure processes were not set up to handle the massive accumulation of bad debt that has developed. Partial improvements have been made particularly in the area of human resources. In the Tokyo District Court, the capacity for foreclosure proceedings is increasing somewhat due to more staff being added. However, these remedial measures may turn out to be inadequate when DIC subsidiaries actually start using the judicial foreclosure process as part of their collection activities. The legal system is not currently ready to handle this possibility; in preparation, legislators and business leaders will need to adopt market-oriented solutions and perhaps amend current laws or even create new laws. For example, the court system should be allowed to temporarily outsource additional work to third-party contractors. Another helpful measure would be to amend the body of law that protects vested interests such as debtors, tenants, occupants and etc. Historically Japanese law has worked to protect debtors, tenants, and occupants from the imposed authority of landlords. This tendency toward strong tenant and occupant protection has led to practices which continue to make bad debt restructuring difficult; certain practices such as shorter lease terms and higher opportunity costs for investors if the investment requires eviction, continue to discourage the trade of underlying collateral which impedes debt restructuring.

Another general characteristic in the Japanese market which affects restructuring activities is the regulation and administration of land use. Traditionally Japan has developed a patchwork of land use regulation which lacks consistency and makes real estate transactions difficult in general, and in particular when combined with the inheritance tax structure. This has raised the land-value-to-rent-earning ratio so extremely high that foreign investors are wary of Japanese real estate investment. Further, the combined effect of inheritance tax, real estate related taxes and land use regulation has encouraged owners to hold on to real estate rather than trade it.

The very arbitrary nature of Japan's tax treatment of loan restructuring losses has also played a role in holding up the development of the restructuring process. The National Tax Administration views tax revenue maximization as a primary objective and the banking sector has been very important in this regard because it has been the largest tax payer in the post war period. Unless very strict conditions are met, the NTA has been reluctant to grant tax deductibility for losses generated by loan restructuring and because of the discretionary power of the NTA, bankers have been hesitant to negotiate with the NTA. This pattern has stifled the sale of bad assets to third party investors.

One impetus for creating CCPC and other bad banks in the early 1990's was to address the tax deductibility issue. Banks were provided the option (through new regulations devised by MoF and supported by NTA) to sell their bad assets to CCPC and other approved bad banks, and under these conditions they could automatically claim tax deductible losses. However, this mechanism also became a delaying factor in bad debt restructuring. Banks were not incentivized to sell to the market their charged-off assets still on the books, since, if they sold their bad assets directly to investors they had to negotiate with tax authorities on a case-by-case basis in order to obtain rulings on tax loss deductibility. Given these conditions, and the difficulties inherent in dealing with governmental bureaucratic authorities, bankers chose to sell their bad assets to bad banks rather than investors. Further, because banks could recognize tax losses immediately under the new system, there was no incentive for banks to sell the written-off assets held by bad banks (or for that matter, good banks). It seems clear that the discretionary power given to the NTA has created implications for tax paying institutions as well as the economy in general, which has pushed forward the bad debt crisis in Japan rather than helping to "put the brakes on" during the current crisis. In fact, this formation of "bad banks" might be, in the most candid terms, seen as a public subsidy to the banking industry in the form of granting a generous tax deduction. It is hard to believe that during the Jusen debate, the opposition party never pointed out this fact--that since the establishment of CCPC the banking sector has routinely been subsidized by tax payers.

Many analysts feel that the ambiguous relationship between Japanese banks and discretionary tax authorities is a key reason that Japanese banks prefer to sell collateral properties rather than to sell loans. A selling bank has to prove to tax authorities that the recovery achieved by the disposition reflects fair market value of the asset and it is commonly felt that establishing a value for real property is easier than evaluating value on loan receivables. Further the tax authority has consistently ruled that losses can be claimed only if borrowers are bankrupt. The argument goes that a non-bankrupt borrower theoretically could be able to repay his debt if given extra time. This argument, combined with the prevalence of recourse loans, has discouraged banks from selling, at a discount, non-performing loans extended to non-bankrupt borrowers. Instead banks often take partial repayment by disposing of collateral property and hold the remaining loan balances on the books (so-called "nin-i baikyaku" or voluntary sales of collateral properties).

Recent Transactions and Announced Transactions

There is some evidence, although circumstantial, that Phase II is on its way. Several banks have issued secured Euro-yen notes backed by real estate collateral of their bad loans. Mitsubishi Bank issued two such notes, the first one in July 1995 and the second in August 1996. Both are 5+ year zero coupon yen notes of approximately 10 billion yen face value each and 70% of the principal of the first note is guaranteed by the bank; similarly, 70% of the principal of the second note is guaranteed by the bank and the remaining 30% is guaranteed by Goldman Sacks. Each issue is said to be placed with a single investor. Fuji Bank also issued notes using a portfolio of REOs whose market value approximates 4 billion yen to secure a 950 million yen 5-year senior secured interest bearing note. The notes were placed with multiple institutional investors. Fuji Bank retains a 3.05 billion yen 5-year subordinated tranche. To all indications, Sanwa Bank and Asahi Bank are issuing a similarly secured note. Due to discretionary tax rulings communicated by the National Tax Administration, all secured notes issued so far have been secured by a portfolio of REOs and not by a portfolio of mortgage loans.

Further, in the past few months a new trend has emerged; stronger banks are becoming more serious about the disposition of their charged-off assets from their balance sheets. The strongest of these banks are indicating a desire towards bulk sale. Perhaps they are realizing that the disposal of their charged off assets to third parties is the best way for them to regain lost credit ratings and international competitiveness; some may be making a declaration to the international credit market that they are no longer dependent on the Japan system and its emcee, the Ministry of Finance. Bank of Tokyo-Mitsubishi announced in the beginning of April that it had sold a portfolio of non-performing loans to an overseas investor.

CCPC has also been involved in dispersion activities. CCPC has been selling collateral real estate properties that secured the loans assigned to the CCPC by banks. CCPC has acquired since its inception and up until the end of March of 1997, a total of 9,776 loans that were secured with 17,515 collateral real estate properties. The total book value of the acquired loans is 13,580 billion yen with an acquisition value of 5,413 billion yen, implying an average price of 39.9%. So far CCPC has sold 4,252 properties, or 24.3% of its total collateral assets, to recover 814 billion yen. The recent trend in asset disposition at CCPC can be seen by looking at the average monthly sales: for the first half of 1993 they sold 2 properties per month, 6 in the second half of FY 93, 39 in 1H of FY 94, 61 in 2H of FY 94, 88 in 1H of FY 95, 133 in 2H of FY 95, 173 in the first half of FY 96, and 200 in the second half of FY 96, which ended this March. According to CCPC officials, most of these properties were sold to third-party buyers. And CCPC has initiated about 70 foreclosure proceedings but so far has only succeeded in completing a few sales. Here again, the collection activities are somehow restricted to collateral property sales rather than note sales despite the fact that the CCPC Articles of Incorporation list selling mortgage loans as one of the options in the description of stated business activities.

Lastly, an increasing number of smaller banking institutions and non-bank financial institutions ("non-banks") whose safety-nets have been cut off by the establishment of DIC subsidiaries have started taking matters into their own hands. They are carrying out restructuring possibilities including portfolio restructuring and filing for bankruptcy protection. According to a Teikoku Databank report, 14,859 bankruptcy filings were made among firms with more than 10 million yen liabilities during FY 1996, which ended in March 1997. The total amount of affected debts was 9,189.6 billion yen which was larger than the FY95 figure by 9.2%.

In addition, at least six consolidations among shinkin banks have already been announced since the beginning of this year. Unlike credit co-ops, which were allowed through public debate and political referendum in 1996 to fall back on the protective services of the Resolution and Collection Bank, the shinkin banks and second-tier regional banks were left without any specific official rescue packages. Therefore, they may not have any other alternative but to consolidate with other institutions.

Consolidation may be occurring on other levels also in the Japanese banking industry. In the beginning of April Nippon Credit Bank announced a major restructuring plan which calls for its exit from overseas operation and liquidation of its non-bank subsidiaries. At nearly the same time Hokkaido Takushoku Bank and Hokkaido Bank announced their merger with a new focus on becoming a super regional bank.

These activities indicate some optimism for the possibility of bad debt restructuring and dispersion of bad debt ownership in Japan.

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